HealthSouth Corp. (HLS) Q2 2014 Earnings Call

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PARTICIPANTS

Corporate Participants

Jay F. Grinney – President, Chief Executive Officer & Director, HealthSouth Corp.
Douglas E. Coltharp – Chief Financial Officer & Executive Vice President, HealthSouth Corp.
Mark J. Tarr – Chief Operating Officer & Executive Vice President, HealthSouth Corp.
Mary Ann Arico – Chief Investor Relations Officer, HealthSouth Corp.

Other Participants

Whit Mayo – Analyst, Robert W. Baird & Co., Inc. (Broker)
Frank G. Morgan – Analyst, RBC Capital Markets LLC
Jack Meehan – Analyst, Barclays Capital, Inc.
Rob M. Mains – Analyst, Stifel, Nicolaus & Co., Inc.
Darren Lehrich – Analyst, Deutsche Bank Securities, Inc.
Chris D. Rigg – Analyst, Susquehanna Financial Group
Gary Lieberman – Analyst, Wells Fargo Securities LLC
A.J. Rice – Analyst, UBS Securities LLC
Joanna S. Gajuk – Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to HealthSouth Second Quarter 2014 Earnings Conference Call. At this time, I would like to inform all participants that their lines will be in a listen-only mode. After the speakers' remarks, there will be a question-and-answer period. [Operator Instructions] You will be limited to one question and one follow-up question. Today's conference call is being recorded. If you have any objections, you may disconnect at this time.

I will now turn the call over to Mary Ann Arico, Chief Investor Relations Officer.

Mary Ann Arico, Chief Investor Relations Officer

Thank you, Maria, and good morning, everyone. Thank you for joining us today for the HealthSouth second quarter 2014 earnings call. With me on the call in Birmingham today are Jay Grinney, President and Chief Executive Officer; Doug Coltharp, Executive Vice President and Chief Financial Officer; Mark Tarr, Executive Vice President and Chief Operating Officer; John Whittington, Executive Vice President, General Counsel and Corporate Secretary; Andy Price, Chief Accounting Officer; Ed Fay, Treasurer; and Julie Duck, Senior Vice President, Financial Operations.

Before we begin, if you do not already have a copy, the press release, financial statements, the related 8-K filing with the SEC and the supplemental slides are available on our website at www.healthsouth.com.

Moving to slide two to Safe Harbor, which is also set forth in greater detail on the last page of the earnings release. During the call, we will make forward-looking statements which are subject to risks and uncertainties, many of which are beyond our control. Certain risks, uncertainties and other factors that

could cause actual results to differ materially from management's projections, forecasts, estimates and expectations are discussed in the company's SEC filings, including the Form 10-K for 2013, the Form 10-Q for first quarter 2014 and second quarter 2014 when filed, and previous filings with the SEC. We encourage you to read them.

You are cautioned not to place undue reliance on the estimates, projections, guidance and other forward-looking information presented. Statements made throughout the presentation are based on current estimates of future events and speak only as of today. The company does not undertake a duty to update or correct these forward-looking statements.

Our slide presentation and discussion on the call will include certain non-GAAP financial measures. For such measures, reconciliation to the most directly comparable GAAP measure is available at the end of the slide presentation or at the end of the related press release, both of which are available on our website as part of the Form 8-K filing last night with the SEC.

Before I turn it over to Jay, I would like to remind you that we will adhere to the one question and one follow-up question rule to allow everyone to submit a question. If you have additional questions, please feel free to put yourself back in the queue.

And with that, I will turn the call over to Jay.

Jay F. Grinney, President, Chief Executive Officer & Director

Great, thank you, Mary Ann, and good morning, everyone. This morning we are very pleased to report the results of another excellent quarter for HealthSouth. Discharges grew 3% despite a challenging 6.3% prior year comp. Net operating revenues were up 7.1% on good volumes and favorable year-over-year pricing.

Adjusted EBITDA increased 13.5% thanks to disciplined expense management and the purchase of an additional 30% equity interest in our Fairlawn Rehabilitation Hospital joint venture, an investment in our core business that contributed $1.4 million to adjusted EBITDA in the quarter.

And finally, adjusted free cash flow came in at $97.9 million, up from $72.5 million last year. These strong operational results allow us to raise our full-year adjusted EBITDA guidance to a range of $570 million to $580 million, up from $555 million to $565 million, and our full-year EPS guidance to a range of $2.25 to $2.31 per share, up from a range of $1.86 to $1.91 per share.

In addition to executing our operational business plan, we also paved the way for future growth. We continue the development of three new hospitals with a total of 134 beds which are expected to come online in the fourth quarter of this year. Although these new facilities are not expected to contribute to Q4 earnings because of the CMS requirement that a minimum of 30 patients at each hospital must be treated with no reimbursement pending final CMS certification, they will contribute in 2015.

We also executed a definitive agreement with Mountain States Health Alliance to form a joint venture to own and operate Quillen Rehabilitation Hospital in Johnson City, Tennessee and signed an LOI with Memorial Health to form a joint venture to own and operate an inpatient rehabilitation hospital in Savannah, Georgia.

The Quillen joint venture is expected to be operational in the fourth quarter while the Memorial joint venture won't close until early next year. Both are expected to contribute to earnings growth in 2015. Our development pipeline remains strong and we hope to announce other growth opportunities by year end.

Finally, in addition to delivering strong operational results and investing in future growth, we returned capital to shareholders in the quarter by repurchasing 494,321 common shares for $16.7 million under our existing authorization and paid a quarterly cash dividend of $0.18 per share on April 15. Year-to-date,

we have repurchased 1.3 million common shares for $43.1 million, and on July 17, our board approved a 16.7% increase in the quarterly dividend to $0.21 per common share.

I'll now turn the agenda over to Doug for a more detailed review of our results.

Douglas E. Coltharp, Chief Financial Officer & Executive Vice President

Thank you, Jay, and good morning, everyone. As Jay highlighted, we're pleased to report on another strong quarter for HealthSouth. Our revenue increased by 7.1% over Q2 2013 driven by inpatient revenue growth of 8% which benefited by approximately 80 basis points from the previously disclosed acquisition of an increased equity interest in our Fairlawn hospital.

The growth in inpatient revenue was comprised of 3% discharge growth and a 4.9% increase in revenue per discharge. Discharge growth included same-store growth of 1.4% and new store growth of 1.6%, 60 basis points of which related to Fairlawn.

The 4.9% increase in revenue per discharge arose from several factors: price adjustments from both Medicare and managed care; higher average acuity for the patients we served; and contributions from the three new hospitals that were undergoing Medicare certification in Q2 2013 and therefore were required to treat an initial 30 patients without reimbursement.

Outpatient and other revenue declined by $2.4 million in Q2 2014 as compared to Q2 2013, which included a $1.6 million benefit from state provider tax refunds. We ended the quarter with 17 outpatient clinics as compared to 22 at the end of the second quarter in 2013. There were no clinic closures during the quarter.

Bad debt expense for Q2 2014 was 1.5% of revenue, in line with our expectations and up from 1.2% in Q2 of last year. The year-over-year increase relates to continuing prepayment medical necessity claims reviews and the persistent backlog in the adjudication process for previously denied claims.

During Q2, we generated operating leverage across all three categories of expense aided by the maturation of the three new hospitals that opened in Q2 of last year. SWB for Q2 was 47.2%, an improvement of 130 basis points; hospital-related expenses were 20.3%, an improvement of 60 basis points; and G&A was 3.8%, an improvement of 30 basis points. Adjusted EBITDA for Q2 was $152.7 million, an increase of 13.5% over Q2 last year driven by revenue growth, disciplined expense management and the Fairlawn investment.

For the first six months of 2014 adjusted EBITDA was $296.8 million, an increase of 8.4% over the first half of 2013 even with the $8 million impact from sequestration in Q1.

As you think about adjusted EBITDA for the second half of the year, please recall that the second half of last year included approximately $13 million in favorable self-insurance accrual adjustments inclusive of the lowering of the statistical confidence level, and consider that this year will include the impact of onboarding four new hospitals in the second half, with each subject to the Medicare certification period I referenced earlier in my remarks.

As anticipated, both interest expense and D&A increased in Q2 2014 over Q2 2013. The increase in interest expense resulted from the exchange of the 2% convertible senior subordinated notes for shares of our 6.5% convertible preferred stock completed in Q4 2013. As a reminder, although the exchange results in an increase in reported interest expense, it reduces our preferred dividend creating an annualized cash flow benefit of approximately $10 million.

The increased D&A relates to continued investments in our business, including the clinical information system, which is now installed in 46 of our hospitals with another 5 scheduled to begin this week, and the purchase of previously leased properties which provides an offsetting benefit in occupancy cost.

Diluted EPS from continuing operations for Q2 was $0.81 a share as compared to $1.66 per share in Q2 last year. Diluted EPS for this year included a gain of $0.27 per share related to the Fairlawn transaction, a mark-to-market of our extant equity position to reflect the enterprise value derived from the purchase price. Diluted EPS in Q2 last year included a benefit of $1.15 per share related to an IRS settlement.

As Jay mentioned, the strong cash flow generating capability of our company was evidenced again in Q2 with adjusted free cash flow of $97.9 million. For the first six months of 2014, adjusted free cash flow of $163 million increased $4.8 million over the first half of last year even with the inclusion of approximately $12 million in maintenance CapEx related to equipment purchases made in Q4 2013 that were paid in Q1 2014.

But for this timing difference, adjusted free cash flow for the first half of 2014 would have increased by 10.6%. The cash we generated in the first half of 2014 supported $52.7 million in discretionary CapEx, $43.1 million in common stock repurchases, $31.6 million in common dividends, and the purchase of our increased equity ownership in Fairlawn.

Our balance sheet and liquidity remain very strong as we ended Q2, with just $15 million drawn on our $600 million revolving credit facility and with a leverage ratio of 2.6 times as compared to 2.8 times at year end 2013.

And I believe now we're ready to open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instruction] Our first question comes from the line of Whit Mayo of Robert Baird.

<Q – Whit Mayo – Robert W. Baird & Co., Inc. (Broker)>: Thanks. First question, Doug, can you just go back and elaborate more around your prepared remarks on pricing, just maybe break out how much was acuity, how much was just due to the easy comp with the Medicare certifications, and how much was this discrete Medicare price adjustment? Just trying to get a sense of the underlying trends. Thanks.

<A – Doug Coltharp – HealthSouth Corp.>: Yeah, I'd be happy to, Whit. Obviously in any one quarter, there are a lot of things that are going on that influence our pricing. The two most significant factors leading to the year-over-year improvement in revenue per discharge were the increases in our Medicare and managed care pricing and the increase in the average acuity of our patients.

But we also had a positive impact in Q2 related to the change in prior period cost report true-ups, and these cost report true-ups are a regularly occurring item and they relate to factors such as the low income patient days and also the provision from time to time by CMS of updated SSI factors for prior years. And we had one of those adjustments into Q2 that related to 2012.

And the magnitude of those prior year cost report adjustments in Q2 of this year was amplified by what I would refer to as a change in polarity. And by that, I mean that these factors negatively impacted our aggregate pricing in Q2 of 2013 and positively impacted pricing in Q2 of 2014. So again, this impact was lower than the amount of the impact from the acuity and from the other pricing adjustments, but in terms of order of magnitude, this specific item was about 110 basis points.

<Q – Whit Mayo – Robert W. Baird & Co., Inc. (Broker)>: Just the prior period development?

<A – Doug Coltharp – HealthSouth Corp.>: Pardon me?

<Q – Whit Mayo – Robert W. Baird & Co., Inc. (Broker)>: Just the prior period development from cost reports?

<A – Doug Coltharp – HealthSouth Corp.>: Yeah, just the year-over-year change...

<Q – Whit Mayo – Robert W. Baird & Co., Inc. (Broker)>: Okay.

<A – Doug Coltharp – HealthSouth Corp.>: ...related to the cost report impact.

<Q – Whit Mayo – Robert W. Baird & Co., Inc. (Broker)>: Okay, great. And my follow up just relates more to the convert, and I just want to make sure I'm thinking about this correctly. In your share count that you report, that includes maybe 8 million shares or so from the dilution associated with the convert, but your balance sheet also reflects the $320 million face value. So this is kind of silly, but shouldn't we be excluding the 8 million shares from a valuation purpose? The convert does appear to maybe optically hide $300 million in equity value. So I just want to make sure that we're looking at this correctly.

<A – Doug Coltharp – HealthSouth Corp.>: Yeah, you know, you're hitting on something that we deal with quite frequently as a point of confusion when people are evaluating our company, and that's the tendency to double count the components of our capital structure, sometimes adding in both the face amount of the debt that appears on the balance sheet and also the underlying shares. So you've got to do kind of an either/or. And we recognize that there are a number of potentially confusing elements of our capital structure between the convert and the preferred stock, and then you could probably throw the NOL into that category as well. But yeah, we would agree with your view on that, Whit.

<Q – Whit Mayo – Robert W. Baird & Co., Inc. (Broker)>: Okay. Thanks.

Operator: Our next question comes from Frank Morgan of RBC Capital Markets.

<Q – Frank Morgan – RBC Capital Markets LLC>: Good morning.

<A – Jay Grinney – HealthSouth Corp.>: Good morning.

<Q – Frank Morgan – RBC Capital Markets LLC>: There's been obviously a lot of activity going on in the post-acute space between a lot of the home healthcare potential M&A and the patient criteria on the LTAC side, so I just wanted to get your updated thoughts on – I know you've looked at these areas in the past – kind of get your updated thoughts on how you see that playing out, what your interest is in those areas strategically. And then maybe I'll go ahead and ask my follow-up, which is just to touch on kind of how you see the landscape laying out in – from a DC perspective in terms of the next round of paper works for the doc fix if you have any recon on that side? Thanks.

<A – Jay Grinney – HealthSouth Corp.>: Yeah, what we've said in the past, Frank, is the following with respect to looking at other post-acute services: we don't feel that there's any compelling need to move into adjacent services except for the opportunity to enhance our position in any kind of evolving delivery system that would see us assuming some level of risk and/or being able to offer a full range of services in some kind of coordinated care environment.

We still believe that that evolution is occurring. We're not 100% sure where it's going to end up, so we're going to be interested in any kind of acquisition that would enhance our position in that kind of environment. And certainly, home care is a service that we don't offer today, so that could be attractive. Long-term acute care services is a service that we used to offer. We don't offer it anymore, but we're familiar with it. We could certainly see that as a growth opportunity.

But we also believe that no matter what happens in the delivery system, healthcare will remain a market-driven service. And so we believe very strongly that it makes no sense to invest capital in adjacent services or in other enhancing acquisition opportunities if it means that we're not augmenting and strengthening our existing market position. So, in other words, it doesn't make sense to buy, say, a home health company where we've got home care services in markets where we don't have a hospital. All that means is we've got to get into those markets and build a hospital.

So what we're going to look for are opportunities that enhance our position in our existing markets, and we're looking far and wide at a wide range of growth opportunities.

In terms of the DC perspective, I don't have a crystal ball on that, but my sense is that next year, depending on what happens in the midterm elections, there will be some effort to resolve the doc fix. I don't think that it's going to be a permanent fix; I could be wrong on that. I think the dollar amount is too big. I think whatever happens in the doc fix is going to have to happen within the larger context of fiscal responsibility, debt ceiling, getting our federal budget in order.

And as you know, the midterm elections will help define that debate. If the Republicans take control of the Senate, they maintain control of the House, then it's going to be, in my opinion, 2015 and into 2016 is going to be a showdown between Republican agendas and Democrat agendas. Whether or not bills can get passed in both houses I think would certainly be a lot easier, but then you'd have to get the President to sign those bills. And I just – I don't know if the dynamics in Washington are such that there will actually be able to, you know, see some progress made.

So specific to your question about the doc fix, I mean, I see that as a – if I were to do a crystal ball, I would say that that's going to be kicked down the road yet again next year. And eventually, it's going to have to be fixed, but I don't think it's going to be fixed outside of some larger budget agreement, and I don't see that happening probably until after the 2016 election, depending on the outcome of that election.

<Q – Frank Morgan – RBC Capital Markets LLC>: Thank you.

Operator: Our next question comes from the line of Jack Meehan of Barclays.

<Q – Jack Meehan – Barclays Capital, Inc.>: Hi, thanks, and good morning. I just wanted to follow up on pricing, and I appreciate the commentary, Doug. Just to start, the acuity component of that, could you size how big that was, and then, just how sustainable do think that is through the back half of the year?

<A – Doug Coltharp – HealthSouth Corp.>: The acuity is a trend that we have been seeing for a while now, and I think it relates to two specific things that are highly correlated. One is just the general demographic trend with the increase in life expectancy and the increase in the cohort of the population that is becoming north of 65, we're seeing patients live longer and experience the kind of maladies that lead to a higher acuity in the overall patient population. And then we've put a specific emphasis on being able to treat those patients in a very high quality manner with things like our stroke certification programs.

We do think that it is sustainable. I think we've demonstrated that over the last several quarters. With regard to its specific impact in the second quarter, it was roughly 220 basis points.

<Q – Jack Meehan – Barclays Capital, Inc.>: Got it. And then, at least as I look in the back half of the year, so if my calculator is correct and I'm working the math correctly, I think it implies about 1.5% to 2% pricing growth in the back half year-over-year. I guess, just what are some of the drivers that are going into that? I think we have pretty good visibility around IRF PPS, and it sounds like the acuity is helping. Would you expect that, you know, potentially exceed the high end just based off some of the things we're seeing?

<A – Doug Coltharp – HealthSouth Corp.>: You know, I think you've hit on it. What we can predict with some reliability is the Medicare and the managed care pricing increases that are out there either because of the contractual relationships we have on the managed care side or because of the visibility that we have into the IRF PPS rule.

The other elements of that are difficult to predict, not because, for instance, on the acuity front we think that the trend isn't sustainable, but it can move from quarter-to-quarter. So really what – our pricing

estimates for the second half are predominantly based on the visibility that we have into the Medicare and the managed care pricing components.

<A – Jay Grinney – HealthSouth Corp.>: There also will be a slight drag on pricing in the fourth quarter when we bring these new hospitals on. I think everybody is aware that we have to treat a minimum of 30 patients in any new hospital before we can get our final certification from Medicare. So that's always a drag.

And when we think about Quillen, for example, we're going to be looking for a new Medicare provider number there, so the same impact will occur at that hospital. So there are – there are going to be some things that will also have a negative impact on pricing in the second half.

<Q – Jack Meehan – Barclays Capital, Inc.>: Got it.

<A – Doug Coltharp – HealthSouth Corp.>: And that specific phenomena that we saw lead to the pricing increase in Q2 of this year, and that is we had three new hospitals that opened in the second quarter of last year that were undergoing that Medicare certification period that Jay just mentioned. So pricing was a little depressed last year, and therefore, the year-over-year delta looked larger this year.

<Q – Jack Meehan – Barclays Capital, Inc.>: Got it. And sorry, I know I get one follow-up, but I'm going to sneak in one more. But if it's three or four hospitals, depending on Quillen, that somewhere, call it $2 million is the headwind in the fourth quarter, or like 20 bps to pricing, is that the way to think about it?

<A – Doug Coltharp – HealthSouth Corp.>: Well, you've got the pricing impact. You've also got the fact that you're experiencing some expenses during the ramp-up period, one against which you're not receiving any revenue for the certification period, and two, at a time when the facility opens up it's obviously not yet at full occupancy.

<Q – Jack Meehan – Barclays Capital, Inc.>: Got it. Okay.

<A – Doug Coltharp – HealthSouth Corp.>: There's an EBITDA impact that extends beyond just the pricing impact, and that's factored into our guidance.

Operator: Our next question comes from the line of Rob Mains of Stifel.

<Q – Rob Mains – Stifel, Nicolaus & Co., Inc.>: Thanks, good morning.

<A – Jay Grinney – HealthSouth Corp.>: Good morning.

<Q – Rob Mains – Stifel, Nicolaus & Co., Inc.>: Continuing on Frank's Washington line of questions, there's this IMPACT bill that I guess might get voted on this week, and sort of more broadly, when you look at this sector, there are proposals involving post-acute care. You know, site-neutral payments, which strike me as probably inimical to rehab hospitals, and also bundling. Is there any traction for any of these kind of significant revampings of the payment system from your perspective?

<A – Jay Grinney – HealthSouth Corp.>: You know, I think that there is some traction. The fact that the IMPACT bill may be introduced, although we're hearing that it may not before they go on recess. But just as background, I think as everyone knows that bill came out of the Senate Finance Committee and the House Ways and Means Committee and it was a pretty strong bipartisan and bicameral support for looking at post-acute payments and seeing if there was a way to streamline them and to really modernize them.

So I think there's some traction behind that. I don't agree with the thesis though that that's bad for rehab. We don't think that at all, frankly. There's been some recent studies that suggest, and reinforce, I should say, that there are outcome and quality differences between rehabilitation hospitals and skilled nursing

facilities in the patients that we treat in both of those facilities. I think that that's something that is a strength of ours; we've maintained that all along.

And so I think that as the – as Congress and as CMS starts to look at this, I think that those differences will really become evident. And in a site-neutral payment system, for example, you start factoring in readmission rates, returns to the hospital emergency room and so on, other measures, the per day difference between putting a patient in a skilled nursing versus a rehabilitation hospital start to shrink. And in many cases, the advantage really goes to the rehabilitation provider.

So, do I think that there's traction? Yes, I think that there is some. If you look at the IMPACT timeline, what basically they're saying to CMS is, look at this, it's going to take a lot of work, we know that, but by 2022, we want you to come up with a plan for how to improve post-acute payments to providers. So it's certainly going to be a long process. We'll be involved. We'll certainly want to participate in as many pilots as we can.

And then to your question on bundling, we're looking at participating in the post-acute bundling project that will start on January 1. We've already submitted our application; we've been accepted. We're awaiting the data from CMS, and we'll be making some determinations. But based on some preliminary analysis, we see some potential upside for us in that kind of payment system.

So again, our core belief is that in whatever healthcare delivery system that evolves, quality is going to become increasingly important. Quality in outcomes will be more evidence based, it will be available for all to see; it will be something that will differentiate providers. And then the second element of that success equation will be the ability to provide those services on a cost-effective basis. So we think we're set up to be able to adapt and to survive and actually to do very well in whatever kind of delivery system might evolve.

<Q – Rob Mains – Stifel, Nicolaus & Co., Inc.>: Got it. Thanks. And then, my follow-up question, seeing a little bit of movement in terms of wage prices in some sectors. Are you seeing any changes in your wage and benefit rates?

<A – Jay Grinney – HealthSouth Corp.>: Not yet, although that's something that we monitor very carefully. We, as you know, provide merit increases for all employees on October 1 to coincide with the updates that we get from Medicare, and so we'll be looking at that carefully during the balance of the summer and into the early part of the fall and then be making a decision. Right now, we're not seeing anything that is concerning, but clearly, that's on our radar and we'll continue to monitor that very carefully.

<Q – Rob Mains – Stifel, Nicolaus & Co., Inc.>: Okay. Thanks.

Operator: Our next question comes from the line of Darren Lehrich of Deutsche Bank.

<Q – Darren Lehrich – Deutsche Bank Securities, Inc.>: Thanks. Good morning, everybody. I wanted to follow up on, Doug, some of your prepared remarks just as it relates to the provision for doubtful accounts. And it looks like this quarter it was sort of at the upper end of what we've been seeing, so I just want to understand I guess where we are with prepayment reviews, and as it relates to this specific quarter, if there's any prior period adjustments or anything that we should be aware of in that number?

<A – Doug Coltharp – HealthSouth Corp.>: No prior period adjustments. It's kind of a continuation of the trend that we've talked about a lot really since 2010, and that is that from time to time we get certain of our fiscal intermediaries who will target a number of different codes and will begin conducting new prepayment claims denials. We saw some of that activity in Q2.

What compounds it and what's caused our bad debt number to track up over time is this phenomenon that I've mentioned previously, which is a very substantial delay in adjudicating the claims that are ultimately denied, and the delay occurs at the administrative law judge level. It's because there's a very

substantial backlog not only with HealthSouth but with many other providers in the number of denied claims that are pending adjudication, and there simply aren't enough ALJs out there to process those, and as a result, the bad debt balance builds over time.

We're not necessarily seeing a significant increase in the number of claims being denied, and the percentages on which we ultimately prevail has not changed, either. So as you can see from our guidance, we're anticipating that the bad debt level will kind of hang in there at the same percentage for the second half of the year, and that anticipates some continuation in additional claims denials.

<Q – Darren Lehrich – Deutsche Bank Securities, Inc.>: That's helpful, thanks. Okay. And then just one follow-up. Jay, just curious, another maybe government or regulatory-related question. In terms of the VA and all the discussion that's currently being had around maybe the private sector helping with some of the backlog in VA patients, are you seeing that as an opportunity for HealthSouth, and where do you guys fit in in that overall discussion?

<A – Jay Grinney – HealthSouth Corp.>: Well, we certainly hope that it will be an opportunity for us. I think it's too early to know with certainty how that might be structured, but we're very encouraged by the initiatives in Washington to allow the private sector to help the VA meet the needs of these veterans, not only the ones that are coming back from overseas, but also those that have been here for a while. And as you probably know, we have made overtures in the past, several overtures, actually, asking to help, offering to help. We have many hospitals in markets where there are veterans but no VA hospitals. And in the past, we have not been successful.

But I think that given the turmoil within the VA system, the desire to get that fixed and the acknowledgment that the private sector can play a role creates the stage for us to be able to move in and certainly offer our services and hopefully be able to help some of these kids that are coming back.

<Q – Darren Lehrich – Deutsche Bank Securities, Inc.>: Great, thanks.

Operator: Our next question comes from the line of Chris Rigg of Susquehanna International Group.

<Q – Chris Rigg – Susquehanna Financial Group>: Good morning. I actually hopped on pretty late here, but the one question I really want to – or just the one thing I would really love to understand is when you guys think about, you know, capital deployment and dividend policy, share repurchases, I mean, can you just help us think through your philosophy, and specifically, the dividend, whether it's sort of a yield target or a percentage of free cash flow deployed? Something just to put some parameters around, you know, how you're going to deploy your capital over the near to intermediate term? Thanks.

<A – Jay Grinney – HealthSouth Corp.>: Yeah, let me – I'll take the first part of that in terms of how we look to deploy the capital, and then I'll ask Doug to respond to the specific question on the dividends.

But if you look at page 21 of the supplemental slides, that really shows you – and it's something that we've consistently shown for the last couple years – shows you what our priorities are and how we think about investing that free cash flow. Clearly, we want to continue to grow the company. We think there are multiple opportunities to do that. One would be adding beds in existing markets to existing hospitals, fabulous return on that investment. As you know, we're targeting to add new rehabilitation hospitals to our portfolio. We're on track to do that again this year.

We don't believe that there are significant debt pay down opportunities. We're always going to be looking at the balance sheet though and looking for opportunities to enhance ROI. Purchase of leased properties, that is something that will be more episodic and opportunistic, but when those opportunities present themselves, we're certainly going to go in and see if we can acquire and take control of those assets.

And then that really leaves us with the shareholder distribution elements. And we've been pretty consistent. We want to pull those levers when we can. We've bought back shares this year, we bought

back shares last year, and then we initiated the dividend last year and increased it this year. So in terms of how we look at the dividend, I'm going to ask Doug to answer that.

<A – Doug Coltharp – HealthSouth Corp.>: I think it's fair to characterize the board's evaluation of where the dividend ought to be and how it ought to trend as being made within a framework versus being established by a policy. The latter would be more formulaic, paying it as a specific percentage of free cash flow or net income, and that's not the way that our board is operating.

The framework considers a variety of factors such as the ultimate sustainability of the dividend based on a number of different business scenarios that may play out, it looks at the competitiveness of the dividend from a yield perspective and from a trajectory, and it also considers a variety of market conditions. Certainly, the increase that you saw in the dividend by the board in July is reflective of a degree of confidence in the future cash flow generating capacity of this business.

<Q – Chris Rigg – Susquehanna Financial Group>: Great, thanks a lot.

Operator: Our next question comes from the line of Gary Lieberman of Wells Fargo.

<Q – Gary Lieberman – Wells Fargo Securities LLC>: Good morning. Thanks for taking the question. I guess the first question is just looking at the outpatient results. Excluding Fairlawn, it slowed down fairly substantially quarter-to-quarter. Is that solely because of the decreased number of outpatient facilities, or is there anything else going on there?

<A – Mark Tarr – HealthSouth Corp.>: No, hey, Gary, it's Mark Tarr. We actually maintained the number of outpatient facilities. We have 17 clinics that we carried over into this quarter. The outpatient business continues to be a challenge for us. The marketplace itself is very competitive I think, and also a determining factor is as we have seen our program mix lean more and more towards neurological patients, those are patients that are less likely to be able to get back to an outpatient clinic to receive ongoing care and are more likely to receive that outpatient in a home setting. So we'll continue to rationalize the outpatient clinics and sites that we have. We have a number of hospitals that have looked at and determined to close their outpatient program that are hospital based. So we're making the best decisions given the demands and changing marketplaces in our hospitals.

<A – Jay Grinney – HealthSouth Corp.>: And just as a reminder, Gary, we also have embedded in that outpatient line the home care services that we do offer. We have 25 different home care agencies. Some of them serve multiple hospitals. So that's also a component in there. So you've got two moving parts in that outpatient line.

<Q – Gary Lieberman – Wells Fargo Securities LLC>: Okay. And then I guess – sorry?

<A – Doug Coltharp – HealthSouth Corp.>: Last thing, Gary, just remember that Q2 of last year the outpatient number included a $1.6 million state provider tax benefit.

<Q – Gary Lieberman – Wells Fargo Securities LLC>: Got it. Right. And I guess my follow up would be somewhat related to that. The same-store discharge growth for the second quarter was sort of at the lower end of your guidance range, and at the same time, your acuity has gone up. So is there something that you're actively doing, you know, perhaps turning away lower acuity patients to try to drive the acuity higher? Is there some kind of missed opportunity for some lower acuity patients that you could be taking?

<A – Jay Grinney – HealthSouth Corp.>: No, there really isn't. We're certainly not turning away patients who need and deserve the care that we can provide. And if you look on page 24 of the supplemental slides that we issued, if you just look at the last couple years in terms of the differences between same-store and new store, and there are a lot of factors that come into play that will drive the new store number and the same-store number. And so, if you just look at that graph, there's a lot of movement, if you will, in how much is new store and how much is same-store. What we try to do is we try to focus on what's the

overall volume growth and how much of that can we achieve through the same-store? We're also obviously looking at acquiring and adding new facilities so that we can continue to grow the business.

But in terms of the specific question, are we doing anything to manage the acuity, no, we're not. And we're certainly not turning away patients who would qualify for inpatient admission and would benefit from that care.

<A – Doug Coltharp – HealthSouth Corp.>: Yeah, Gary, I think you also have to put that in the context of the fact that as Jay mentioned in his remarks, Q2 of this year was up against the toughest comparison in terms of last year's growth that we have faced since Q1 of 2011. We had the 6.3% discharge growth in Q2 of 2013 that we were up against.

<Q – Gary Lieberman – Wells Fargo Securities LLC>: Okay, great. Thanks very much.

Operator: Our next question comes from the line of A.J. Rice of UBS.

<Q – A.J. Rice – UBS Securities LLC>: Hi, everybody. Maybe if I could ask first real quick, on adjusted EBITDA, it looks like for the first half, you've done about $296.8 million. The midpoint of your guidance for the back half is $278 million. Obviously, in the first quarter, you had some weather and sequestration impact. I guess I'm trying to gauge what factors would impact you in the back half of the year that would make that less than the front half. I would think they'd be about the same. Maybe part of it's the start-up of the new facilities, but any thoughts to put that in perspective?

<A – Doug Coltharp – HealthSouth Corp.>: Yeah, it's – A.J., it's Doug, and I think, again, as you're looking at the year-over-year comparison for the second half, the two things that I would point to are the favorable adjustments to the self-insurance accruals that we had in the second half of last year and then also the impact of the start-up of the new hospitals.

<Q – A.J. Rice – UBS Securities LLC>: In this year's – this year it'll impact you. Do you have a sense of how much those would be?

<A – Doug Coltharp – HealthSouth Corp.>: We're not quantifying that, other than to say that it is in our guidance for the rest of the year.

<Q – A.J. Rice – UBS Securities LLC>: Okay. And I was just wondering if maybe on the – a quick question on reform. I'm seeing in your payor mix Medicare is down a little bit, Medicaid's up a bit, as is managed care. Do you think that's reform driven? Are you seeing any spillover effect in any way from reform do you believe in the number?

<A – Jay Grinney – HealthSouth Corp.>: A.J., we're – we don't know, to be honest, if there is any effect. It's happening really in two states is where we're seeing the impact on the Medicaid side. I think it's too early to tell. I would hope that there would be opportunities to provide more care to Medicaid beneficiaries, but we just don't know at this point.

<Q – A.J. Rice – UBS Securities LLC>: Okay. All right, thanks a lot.

Operator: [Operator Instructions] Our next question comes from the line of Kevin Fischbeck of Bank of America Merrill Lynch.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: Actually, this is Joanna Gajuk for Kevin today. Just, if you could talk a little bit more about the ramp-up of de novos and JVs. I appreciate the comment that you don't expect that the new hospitals could contribute this year, but you do expect them to contribute to earnings next year. So, just in growth terms, you know, doesn't have to be very specific, but in general, how do you feel about the margin progression on de novos and also on JVs over time? Thank you.

<A – Doug Coltharp – HealthSouth Corp.>: Yeah, I think we have a – there's a slide in our Investor Reference Book – I forget which specific page it is – that shows the ramp-up of our de novos over a multi-year period. And I think that can help you gauge how quickly we're typically able to get a new hospital. And in the existing version of the Investor Reference Book, it's page 75. So you can find that at our website, and obviously it will be updated again here in the very near future. But that can give you a pretty good sense as to when we're able to achieve our standard run rate of occupancy at a new facility, and there's a lot of consistency in those numbers. And obviously occupancy then drives the sustainable level of positive EBITDA. So we typically get them there pretty quickly, and that's why we're confident that those new hospitals that are coming on board in 2014 will be making a positive EBITDA contribution to 2015, and when we move into 2015, that'll be factored into our guidance.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: Great, thanks. And just a quick follow-up. Do I get it right with the – it feels like maybe you pushed back the opening of de novo in Modesto a little bit? Is there any reason for that, or just nothing really there to point to? Thank you.

<A – Jay Grinney – HealthSouth Corp.>: Yeah, that has to do exclusively with the process that we have to go through OSHPD there in California. So that's not a push back on our behalf, it's just – it's a pretty detailed process to go through in getting hospitals approved through that agency, and it's just a reality of working in California. But we are looking forward to getting a favorable ruling and favorable outcome and then be able to move forward very quickly.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: Great, thanks.

Operator: At this time, I'm showing no further questions. I would now like to turn the floor back over to management for any additional or closing remarks.

Mary Ann Arico, Chief Investor Relations Officer

Thank you, Maria. As a reminder, we will be filing the updated Investor Reference Book in mid-August and attending the Baird Healthcare Conference in early September. If you have additional questions, I will be available later today. You can call me at 205-969-6175. Thank you. Maria, that concludes for us.

Operator: Thank you. This concludes today's HealthSouth second quarter 2014 earnings conference call. You may now disconnect.

Mary Ann Arico, Chief Investor Relations Officer

Thank you.